Pfizer is a leading global developer and manufacturer of pharmaceuticals. Its products include Lipitor, Lyrica, Prevnar, Viagra, Advil and Ibrance.

**Analyst’s Notes**

*Analysis by Stephen Biggar and Jasper Hellweg, May 24, 2017*

**ARGUS RATING:** HOLD

- Maintaining HOLD on challenging revenue growth
- We see limited near-term upside for PFE given upcoming patent expirations, prospects for increased competition, and the divestiture of Hospira Infusion Systems.
- On May 2, Pfizer reported 1Q17 adjusted EPS of $0.69, up from $0.67 in 1Q16. EPS came in $0.04 above our estimate and $0.02 above the consensus forecast.
- We are maintaining our 2017 adjusted EPS estimate of $2.56, but are lowering our 2018 estimate to $2.69 from $2.80 to account for the Hospira sale and the loss of exclusivity for Viagra.
- Based on the company’s current challenges, we believe that the shares are fairly valued at 12.6-times our 2017 EPS estimate, below the average of 15.2 for mature pharma peers. We believe that the discount is appropriate given Pfizer’s slower growth profile.

**INVESTMENT THESIS**

We are maintaining our HOLD rating on Pfizer Inc. (NYSE: PFE). We see limited near-term upside for PFE given upcoming patent expirations, prospects for increased competition, and the divestiture of Hospira Infusion Systems (HIS). On the positive side, we note that Pfizer beat the consensus EPS estimate in 1Q, reversing two consecutive quarters of misses.

Pfizer’s Essential Health business has languished, with a decline in operational revenue in the first quarter, and several key drugs are set to lose patent exclusivity over the next two years. Management also plans to keep drug price percentage increases in the low single digits, apparently in an effort to deflect public criticism. Although the Innovative Pharmaceuticals segment has generally performed well, with strong sales of Prevnar and Ibrance, market growth is slowing and competition is increasing. The company has also discontinued work on a cholesterol-lowering drug. However, we expect Pfizer to continue to bolster its pipeline with acquisitions, such as its $14 billion purchase of Medivation in two years. Management also plans to keep drug price percentage increases in the low single digits.

Based on the company’s current challenges, we believe that the shares are fairly valued at 12.6-times our 2017 EPS estimate, below the average of 15.2 for mature pharma peers. We believe that the discount is appropriate given Pfizer’s slower growth profile.

**Market Data** Pricing reflects previous trading week’s closing price.

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| Annual | 48.9 | 52.8 | 53.8 | 55.1 |

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Please see important information about this report on page 5

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need to see a change in strategy, or a nonfundamental pullback to the high $20s, before returning the stock to our BUY list.

RECENT DEVELOPMENTS

PFE shares have underperformed the market over the past three months, falling 6.3% while the S&P 500 has risen 1.2%. Over the past year, they have also underperformed, with a loss of 6.5% versus a gain of 14.7% for the index. The beta on PFE is 1.04, slightly above the peer average.

On May 2, Pfizer reported 1Q17 adjusted EPS of $0.69, up from $0.67 in 1Q16. EPS came in $0.04 above our estimate and $0.02 above the consensus forecast. The increase was primarily due to a lower effective tax rate on non-GAAP adjusted income and lower operating expenses, partly offset by lower revenue and a decline in 'other income.' The adjusted results exclude acquisition costs and discontinued operations. GAAP EPS rose to $0.51 from $0.49 in 1Q16.

First-quarter revenue totaled $12.8 billion, down 1.7% from 1Q16, as a 5% increase in Innovative Health revenue was more than offset by a 10% decline in Essential Health revenue. Currency translation had a -1% adverse impact. The quarter had one less domestic and two fewer international selling days, which lowered revenue by $300 million relative to the prior year. Adjusted net income rose 0.4% to $4.2 billion. The operating margin rose to 42.3% from 42.1%.

For drug companies, we typically focus on the growth of blockbuster drugs. For Pfizer, those are Lyrica (for nerve pain) and Enbrel (for psoriasis and rheumatoid arthritis). Combined operational revenue for these drugs fell 5.2%, to $1.86 billion, in the first quarter and accounted for 14.5% of total revenues. Enbrel sales have been hurt by the launch of biosimilars in Europe.

Pfizer’s Innovative Health business recorded 5.4% revenue growth in 1Q17, driven primarily by Ibrance, Eliquis, Xtandi, Lyrica, and Xeljanz, partly offset by lower sales of Prevnar 13. Revenue in Pfizer’s Essential Health business declined 10.2% in 1Q, largely due to lower sales of legacy established products and lower Hospira revenues due to the sale of this business in February 2017, partially offset by growth in the Sterile Injectables portfolio and in Biosimilars.

First-quarter sales of Pfizer’s top revenue generator, Prevnar, fell 7.8% to $1.4 billion. The decline reflected the timing of government purchases for children in international markets and reduced prescriptions for adults in the US. Management expects Prevnar sales to be flat to slightly lower in 2017.

Ibrance is a new treatment for metastatic breast cancer. Sales rose to $679 million in 1Q17 from $429 million in 1Q16, and management expects continued sales growth. In November 2016, the company received EU approval for Ibrance in combination with endocrine therapy for the treatment of HR+, HER2- advanced or metastatic breast cancer, as well as for the treatment of recurrent advanced breast cancer. The drug is also being studied for additional breast cancer indications. While Ibrance is the market...Continued
leader, it will soon face competition from new Eli Lilly and Novartis products; however, management expects sales to remain strong despite the increased competitive pressure.

One of Pfizer’s most promising pipeline drugs is Avelumab (for skin cancer), which has been granted fast-track status by the FDA. In July 2016, Pfizer announced the initiation of a Phase 3 study to evaluate the efficacy and safety of the drug. The company expects to see early data from a variety of Avelumab studies in 2017. Avelumab is also being reviewed by the European Medicines Agency. Management expects to have one or more approvals per year for Avelumab between 2017 and 2022.

The company expects to lose patent exclusivity for several products over the next few years, including Viagra in the U.S. in December 2017 and Lyrica in the U.S. in December 2018. However it also expects up to 10 approvals for new products in 2017-2018. The company currently has 96 potential products in clinical development.

On February 3, the company completed its sale of Hospira Infusion Systems to ICU Medical Inc. for 3.2 million newly issued shares of ICU Medical, valued at approximately $428 million, a $75 million promissory note, and net cash of $200 million (before adjustments for working capital). Pfizer may also receive up to an additional $225 million in milestone payments. PFE now owns approximately 16% of ICU Medical.

Along with its 1Q report, management reaffirmed its 2017 financial guidance. It continues to expect 4% growth in operational revenue and 10% growth in operational adjusted diluted EPS, excluding the negative impact of foreign exchange and the Hospira divestiture.

EARNINGS & GROWTH ANALYSIS

Looking ahead, we expect Pfizer to benefit from new drugs and acquisitions, but see the pipeline as relatively weak following the discontinuation of development work on bococizumab, a treatment for high cholesterol. We project 2017 revenue of $53.8 billion, up 2% from 2016, which assumes steady growth from oncology drugs such as Ibrance. Our estimate also assumes contributions from cancer drug Xtandi, which was acquired through the purchase of Medivation. While 1Q results came in ahead of our expectations, we are maintaining our 2017 adjusted EPS estimate of $2.56 based on assumptions for high costs and increased competition. We are lowering our 2018 estimate to $2.69 from $2.80 to account for the Hospira sale and the loss of patent exclusivity for Viagra.

FINANCIAL STRENGTH & DIVIDEND

We rate Pfizer’s financial strength as Medium-High, the second-highest rank on our five-point scale. The company had $14.6 billion in cash and short-term investments at the end of the first quarter, down from $17.9 billion at the end of 1Q16. Combined with its debt-raising ability, Pfizer has ample resources to acquire smaller firms, like Medivation, or individual drugs. In 1Q17, EBIT covered interest expense by a factor of 12.8, up from 11.6 a year earlier. Total debt/capital was 42.8%, in line with the...Continued
peer average. The 1Q adjusted operating margin was 42.3%, up from 42.1% in 1Q16.

Following management’s decision to shelve its plan to split up the company, Moody’s raised its outlook on PFE debt to stable from negative in September 2016; Moody’s rating is A1. S&P rates the debt AA, also with a stable outlook.

Pfizer pays an annual dividend of $1.28, for a yield of about 4.0%, above the peer average of 2.7%. It raised the quarterly payout by 7% with its 1Q payment. Our dividend estimates are $1.28 for 2017 and $1.32 (reduced from $1.28) for 2018.

As of April 2, 2017, the company had $6.4 billion remaining on its current $11 billion stock buyback authorization, which began in December 2015. In February 2017, it repurchased $5 billion of its stock under an accelerated share repurchase agreement with Citibank.

**RISKS**

Risks for Pfizer include the loss of patent protection, product development setbacks, and political and regulatory hurdles.

The drug distribution industry has consolidated, raising the risk that pharmacy benefit managers may be able to use economies of scale against drug manufacturers. Several pharmacy benefit managers account for 8%-10% each of Pfizer’s revenue, including CVS Caremark, McKesson, Cardinal Health and AmerisourceBergen.

**COMPANY DESCRIPTION**

Pfizer is a leading global developer and manufacturer of pharmaceuticals. Its products include Lipitor, Lyrica, Prevnar, Viagra, Advil and Ibrance.

**VALUATION**

At current prices near $32, PFE shares are trading below the midpoint of their 52-week range of $30-$37. Based on the company’s current challenges, we believe that the shares are fairly valued at 12.6-times our 2017 EPS estimate, below the average of 15.2 for mature pharma peers. We believe that the discount is appropriate given Pfizer’s slower growth profile. We would need to see a significant change in strategy, such as a reconsideration of the separation plan, or a nonfundamental pullback to the high $20s, before returning the stock to our BUY list.

On May 24, HOLD-rated PFE closed at $32.05, down $0.09.
About Argus

Argus Research, founded by Economist Harold Dorsey in 1934, has built a top-down, fundamental system that is used by Argus analysts. This six-point system includes Industry Analysis, Growth Analysis, Financial Strength Analysis, Management Assessment, Risk Analysis and Valuation Analysis.

Utilizing forecasts from Argus’ Economist, the Industry Analysis identifies industries expected to perform well over the next one-to-two years.

The Growth Analysis generates proprietary estimates for companies under coverage.

In the Financial Strength Analysis, analysts study ratios to understand profitability, liquidity and capital structure.

During the Management Assessment, analysts meet with and familiarize themselves with the processes of corporate management teams.

Quantitative trends and qualitative threats are assessed under the Risk Analysis.

And finally, Argus’ Valuation Analysis model integrates a historical ratio matrix, discounted cash flow modeling, and peer comparison.

THE ARGUS RESEARCH RATING SYSTEM

Argus uses three ratings for stocks: BUY, HOLD, and SELL.

Stocks are rated relative to a benchmark, the S&P 500.

• A BUY-rated stock is expected to outperform the S&P 500 on a risk-adjusted basis over a 12-month period. To make this determination, Argus Analysts set target prices, use beta as the measure of risk, and compare expected risk-adjusted stock returns to the S&P 500 forecasts set by the Argus Market Strategist.

• A HOLD-rated stock is expected to perform in line with the S&P 500.

• A SELL-rated stock is expected to underperform the S&P 500.

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